

the legislators that they have additional funds to spend for expansion proposals. The negative revenue growth from 1990 to 1991 revealed the shortcomings of the continuation/expansion approach to budgeting. Without growing revenues, the State cannot continue to fund all existing programs. The 1991-1993 biennial budget process required a long overdue evaluation of the relevance and effectiveness of existing programs.

Recommendation: Eliminate separate consideration of the continuation and expansion budgets.

To enable legislators to vote for an efficient allocation of resources to State agencies, the legislature should consider the relative benefits and costs of all State expenditures. All proposed expenditures should be reviewed during the same time period.

The General Assembly should require that the Governor present a budget that makes no distinction between continuation and expansion but that indicates the total proposed level of funding for each agency.

If the post April 15 revenue update, that occurs during the course of budget deliberations indicates an increase in year-end fund balances, the General Assembly should dedicate the remaining revenue to the rainy day fund and to funding the capital budget for building repair and renovations before budgeting for capital improvements.

Finding 5 - The State uses its personal services budget as a rainy day fund.

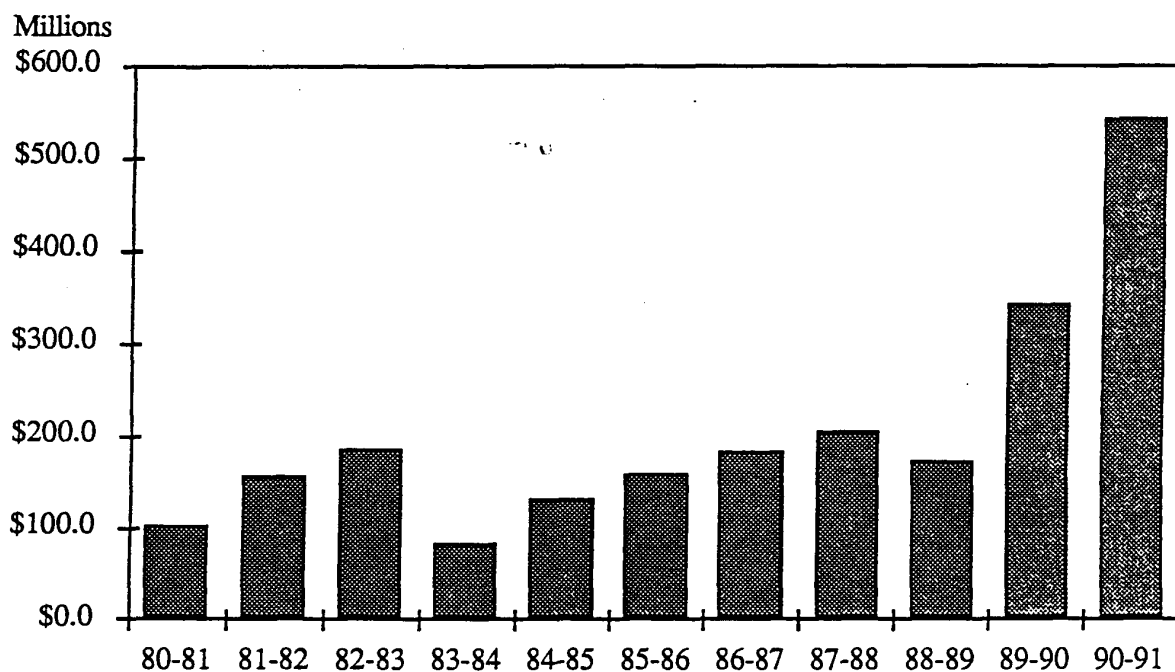
The Governor submits a budget to the General Assembly that includes the amount needed to fund all authorized positions at 100 percent. This means the General Assembly funds the annual salary for positions that are vacant at the beginning of the year although the positions may remain vacant for the entire year. The extra funds budgeted for salaries do more than give program managers flexibility to deal with unanticipated problems, they serve as a rainy day fund for the entire State. At the end of the year, funds remaining in agencies personnel line items revert to the General Fund. For many years, these reversions guaranteed a positive fund balance at the end of the year with which the General Assembly funded capital improvements and other expansion items. Over time, the State has come to rely more and more on full funding of positions as a source of emergency funds. (See Exhibit 3-6.)

In 1991, the General Assembly established a rainy day fund and a mechanism for financing it. The legislature appropriated \$40 million for the State's Savings Reserve (rainy day) account for fiscal year 1992.

For the General Assembly to allocate public resources in an efficient and economical fashion, the budget document must accurately represent agency and program costs. An

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Exhibit 3-6
Reversions to the General Fund 1980-1991
Public Schools, Universities, and Human Resources



Source: Overview: Fiscal and Budgetary Actions, North Carolina General Assembly, 1991 Session

* Includes \$106 million for the 12th month pay period deferred into 1991-92 fiscal year, \$141 million budget stabilization reserve, \$31.4 million local shared revenues/reimbursements, and \$57.4 million employer retirement contribution withheld from the retirement system.

agency is not likely to need all its positions funded at 100 percent because:

- Some vacant positions may not be filled before the end of the fiscal year
- Attrition can cause a position to be vacant for part of the year
- An employee may leave State government at a high grade and salary and be replaced by a person with a lower grade and salary

All of these changes make the real funding need for salaries closer to 95 percent than 100 percent.

For legislators to make a meaningful comparison among State programs, they must know what it costs to operate them. By overbudgeting for salaries, the General Assembly allocates resources to purposes for which they are not needed. Since vacancy rates vary from agency to agency, some agencies need only 90 percent funding for positions while others need 97 percent funding. Overbudgeting for salaries distorts the actual budgetary needs for all State agencies. As a result, legislators are left to make budgetary allocation decisions with less than accurate information.

North Carolina has always funded its salaries at 100 percent. When the number and relative cost of State personnel were lower, the inaccuracy of this method caused little problem. As the State personnel roles grew, the overbudgeting helped to produce a significant positive fund balance at the end of the fiscal year. Today, 5 percent of the personnel budget is equal to about \$331 million.

Recommendations: **Budget for salaries at expected level of staff utilization rather than overbudgeting intentionally to finance capital expenditures**

Expedite full funding for the State's Savings Reserve (rainy day) Account

These recommendations would eliminate the use of reversions as a mechanism for funding capital projects. Overbudgeted salaries are now the primary source of funds for the State's capital improvement projects. If salaries are budgeted at their expected level of utilization, reversions to the General Fund would shrink significantly. The State would have to identify other sources for funding capital improvement projects including bond financing. A reduced appropriation for salaries to correspond to the expected level of staff utilization would free budgetary resources to allow the General Assembly to budget 5 percent of the General Fund budget for the new Savings Reserve Account.

Finding 6 - The State's budget format encourages legislators to focus on control issues rather than on government management and policy issues.

The North Carolina budget document is lengthy and complicated. It comprises six volumes, includes 3,500 pages, and 10,000 line items. The budget encourages the reader to focus on line item detail rather than legislative intent and program results. The North Carolina budget format is a hybrid of several budget formats. Fundamentally, it is a line item budget, but it includes some characteristics of a performance budget and a program budget. The basic organizational structure for the budget document is shown in Exhibit 3-7.

Similar programs may not appear together in the North Carolina budget document and are reviewed by separate subcommittees. Similar programs located in different agencies are not cross-referenced in the document and are reviewed by different appropriations subcommittees. Examples of similar programs that cross agency and appropriations subcommittee lines are shown in Exhibit 3-8. A budget that includes a grouping of similar programs would allow legislators to compare the relative effectiveness of different approaches to a problem, discover unnecessary duplication of effort, or discover how statutory directives split services among groups within the population.

The influence of the budget format has been described by Allen Schick's *Road to PPB*. This article suggests that the manner in which legislators approach, discuss, and deliberate over budgets can be classified into three categories--control, management, and planning. These three orientations are described below.

- **Control orientation.** A budget format based on line item detail elicits a control orientation from legislators. In responding to a line item budget, appropriators focus on spending ceilings and limits on agency spending by objects.
- **Management orientation.** A budget format organized around a government's activities, i.e., agencies and organizational units, elicits a management orientation from legislators. In responding to an organizational unit budget, appropriators focus on quantity, quality, and cost per unit of output.
- **Planning orientation.** A budget format organized by program elicits a planning orientation. The range of concerns of legislators tends to focus on long-range planning goals and policies and how these relate to terminating, expanding or curtailing particular programs.

Schick's research indicates that most budget processes combine all three orientations. One may be dominate, but the other two are always present.

North Carolina's budget format encourages a control orientation and deemphasizes the management and planning orientations. Instead of focusing on policy priorities, program effectiveness, and program management, appropriators have tended to focus on control over budgeted line items. A study of the North Carolina appropriations committees during the 1979 and 1981 legislative sessions suggested that the line item budget format caused appropriators to focus on control issues. The same study suggested that a program budget

Exhibit 3-7 North Carolina Budget Structure

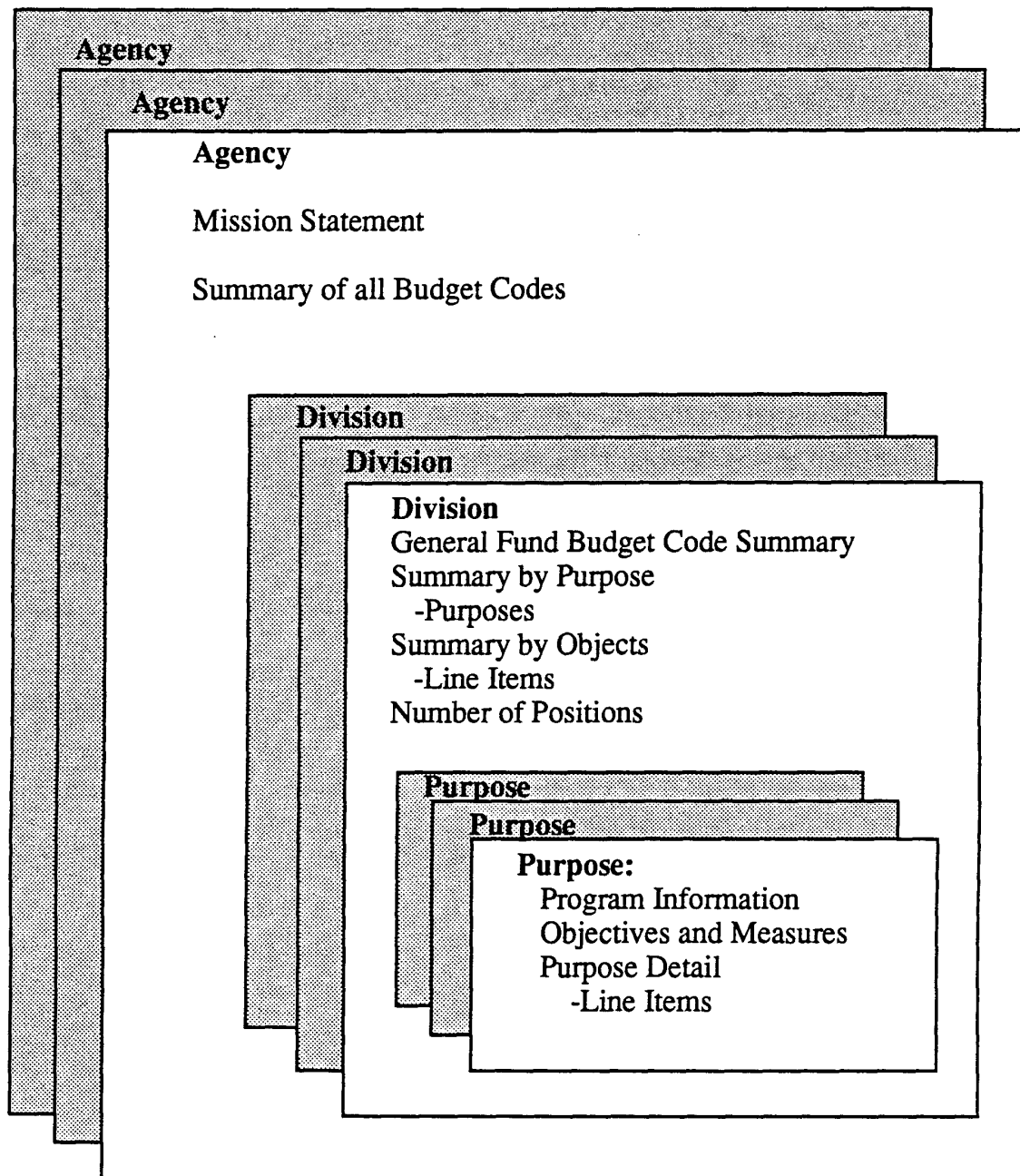


Exhibit 3-8
Similar Programs Cut Across
Agency and Subcommittee Lines

Program Area	Selected Departments with Program Responsibility	House Appropriations Subcommittee Jursdiction	Senate Appropriations Subcommittee Jursdiction
Worker Training Programs	Employment Security Commission	General Government	General Government
	Community Colleges	Education	Education
	Corrections	Justice and Public Safety	Justice and Public Safety
	Human Resources	Human Resources	Human Resources
Prenatal Care Programs			
	Environment, Health, and Natural Resources	Environment, Health, and Natural Resources	Natural and Economic Resources
	University System	Education	Education
	Human Resources	Human Resources	Human Resources

caused appropriators to focus more on management and planning than did the line item budget.

In summary, North Carolina's line item budget, although appropriate for expenditure control, has several drawbacks. Among these are:

- Legislators tend to focus on control issues rather than on management, public policy, and planning issues
- Legislators are not able to see the variety of efforts across State government to address any given issue
- The goals and priorities of the State government are not communicated clearly in a line item budget
- The budget document is too technical for many citizens to understand

The format of the budget is the starting point for discussion of the State's priorities and will need to be changed to improve the State's financial management systems. An increased emphasis on the planning and management orientations will improve upon the State's ability to plan for the efficient allocation of resources to address emerging priorities.

Recommendation: Develop a budget format that focuses on program results and reduces line item detail.

The budget document can be made considerably shorter by detailing agency expenditures by program and reducing line item detail to from five to ten expenditure objects. Instead of listing thousands of different line items in their budgets, South Carolina reports only nine line items (objects of expenditure) and Texas only eight. In both cases, they were able to account for all proposed agency expenditures in less than ten items. To accommodate the General Assembly committee structure and method of voting (the General Assembly votes appropriations to agencies) the alternative budget format must show expenditures by program within the agency or department. A supplementary document that groups programs across agencies should be submitted as an attachment or as Volume II of the budget. An example of an alternative budget format that emphasizes programs within departments rather than line items is shown at Exhibit 3-9.

To implement this recommendation, OSBM should solicit input from the chairs of the House and Senate appropriations committees and subcommittees. After considering input from the legislature, OSBM should initiate a pilot project to deliver a portion of the budget in an alternative format. Based on what is learned through the pilot project, the entire budget should be developed in the alternative format for the 1995-1997 biennium. The General Assembly leadership may want to consider how a change in the

Exhibit 3-9

Key Features of a Program Budget

<i>Example</i>													
PRENATAL CARE													
Goal Statement	Policy Objectives - Full-term babies with high birth weight and few birth defects.												
PROGRAM EFFORTS													
Direct Services													
1) Prenatal care for low-income women (local public health clinics)													
Funding:													
	<table><tr><td></td><td>1989-90</td><td>1990-91</td><td>1991-92</td><td>1992-93</td><td>1993-94</td></tr><tr><td>EHNR1510</td><td>\$10.8M</td><td>\$11.8M</td><td>\$11.4M</td><td>\$11.6M</td><td>\$12.2M</td></tr></table>		1989-90	1990-91	1991-92	1992-93	1993-94	EHNR1510	\$10.8M	\$11.8M	\$11.4M	\$11.6M	\$12.2M
	1989-90	1990-91	1991-92	1992-93	1993-94								
EHNR1510	\$10.8M	\$11.8M	\$11.4M	\$11.6M	\$12.2M								
Outputs and outcomes:													
--number of low-income women receiving care in first trimester													
--reduced numbers of low birth weight babies born to mothers in program													
Cross Departmental Perspective	2) Prenatal care for low-income women (UNC Memorial Hospital)												
	Funding:												
	<table><tr><td></td><td>1989-90</td><td>1990-91</td><td>1991-92</td><td>1992-93</td><td>1993-94</td></tr><tr><td>UNC0100</td><td>\$.5M</td><td>\$.5M</td><td>\$.6M</td><td>\$.6M</td><td>\$.7M</td></tr></table>		1989-90	1990-91	1991-92	1992-93	1993-94	UNC0100	\$.5M	\$.5M	\$.6M	\$.6M	\$.7M
	1989-90	1990-91	1991-92	1992-93	1993-94								
UNC0100	\$.5M	\$.5M	\$.6M	\$.6M	\$.7M								
Outputs and outcomes:													
--number of low-income women receiving care in first trimester													
--reduced numbers of low birth weight babies born to mothers in program													
Outcome Measures													

budget format may affect the committee structure in the House and the Senate.

GPAC has recommended immediate implementation of a results-based budget.

Finding 7 - The State lacks an effective capital budgeting process.

We identified the following two major flaws in North Carolina's capital budgeting process:

- The State lacks a methodology for determining the repair and renovation needs for existing State buildings and a method for funding them
- The State's method for financing capital improvements inhibits planning for and funding of long-term capital needs

Although the State's capital budgeting process lacks many of the elements of good practices in capital budgeting, these two issues are key obstacles to an improved capital budgeting process. The National Association of State Budget Officers suggest several good practices in capital budgeting. Many of these practices are not followed by North Carolina. A listing of the Association's recommended practices and how North Carolina stacks up against them is shown in Exhibit 3-10.

Repair and renovation needs are not funded

The State has a major investment in capital assets. Among its assets are 11,450 State-owned buildings, which, valued at \$4.1 billion, are a tremendous resource and responsibility for the State of North Carolina.

Executive branch requests for repair and renovation funds receive only minimal funding from the General Assembly, and those funds have declined in recent years. The Legislative Research Commission issued a report to the 1991 General Assembly that found major weaknesses in the State's management of capital assets. The Commission reported that in the 1987-1989 biennium, the Governor requested \$188 million for repair and renovation but the General Assembly funded only \$32.5 million. For the 1989-1991 biennium, \$241.1 million was requested, but only \$29.5 million was funded (see Exhibit 3-11). A 1987 study of North Carolina University facilities recommended that from 1.5 percent to 3 percent of the total plant replacement value be set aside for renewal and replacement. Like many other states, North Carolina has deferred maintenance to fund more immediate needs.

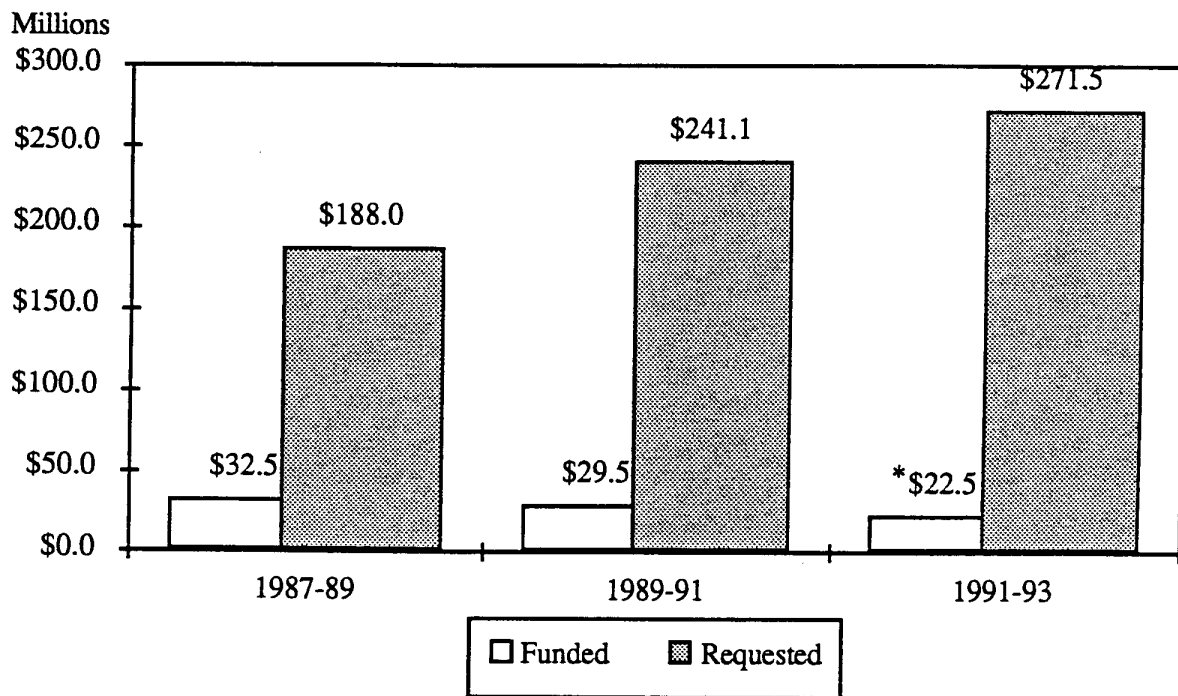
Exhibit 3-10
Good Practices in Capital Budgeting
According to National Association of State Budget Officers

Practices	Followed By NC?
Establish a clear definition of expenditures within the capital budget.	Yes
Define maintenance expenditures and provide for adequate funding of maintenance in statute.	No
Include specific operating costs for each capital project.	Yes (1)
Ensure that effective legislative involvement occurs throughout the capital budgeting process.	Yes
Strengthen the review of the years beyond the budget year in long-range capital plans.	Yes
Identify the criteria used in selecting capital projects.	No
Define all program outcomes for capital investments.	No
Evaluate cost estimating methods to measure their validity.	Yes
Establish a tracking system to keep projects on schedule and within budget.	Yes
Define the factors to consider in decisions to own or lease.	No
Develop a clear debt policy. (2)	No
Review cost-benefit comparisons for private sector participation in capital projects.	No
Maintain an updated inventory system of capital assets.	Yes

(1) The 1991 Session of the General Assembly enacted a law requiring 20 year operation and maintenance costs be included in estimates for all State buildings.

(2) North Carolina has a policy for paying debt before other obligations are paid but it does not have a policy regarding what items should be debt financed.

Exhibit 3-11
Repairs and Renovations
Requested and Funded
(in \$ millions)



* Represents appropriations for 1991-92. Appropriations for 1992-93 are presently under consideration.

Source: State Capital Assets and Improvements, Legislative Research Commission, 1991

Method for financing capital improvements inhibits planning

On occasion, the State has issued bonds to finance capital improvements for educational facilities and prison construction, but generally, it has relied on a pay-as-you-go policy for financing capital improvements. Positive year-end fund balances are the primary source of funds for capital improvements. When they occur, fund balances have resulted primarily from the practice of overbudgeting for salaries. Because more is budgeted and appropriated for salaries than is needed, the State often ends the fiscal year with a fund balance that can then be used to finance the State's pay-as-you-go capital improvement policy.

North Carolina's pay-as-you-go policy for capital improvements financed with General Fund balances has the following implications that reduce the effectiveness of the State's capital budget process:

- Needed capital improvements are delayed until fund balances are available
- The State's long-term capital needs are not identified or addressed systematically
- Today's taxpayers finance improvements that are enjoyed (but are not paid for) by future taxpayers

Other deficiencies in the capital budgeting process include the following:

- North Carolina has not performed a long-range statewide capital needs assessment
- Six-year capital plans from agencies are of varying degrees of usefulness and, like *Departmental Plans*, receive little attention from the General Assembly
- General Assembly decisions on capital improvements are often made near the end of the session without the use of objective evaluation criteria

Because there is no appropriations subcommittee assigned specifically to the capital improvements budget, the capital improvement decisions are generally made at the appropriations subcommittee level. During the 1989-1991 biennial budget deliberations, however, the House held hearings on the capital improvements budget request. The Senate did not hold similar hearings.

With North Carolina's current method of planning for and financing its capital needs, it is nearly impossible for the State to plan for or manage its capital assets. The amount that reverts to the General Fund varies from year to year making it difficult for the State to anticipate the availability of capital improvement funds. Buildings are constructed, repaired, or renovated based on the amount of funds that revert to the General Fund at the end of the year, rather than the manifest need for construction, repairs, and renovations. For North

Carolina, the level of reversions has determined how much the State spends on capital improvements rather than the thoughtful consideration of elected representatives.

Recommendations: Restructure the State's capital budgeting process.

Discontinue use of reversions to finance capital expenditures and budget salaries at expected level of staff utilization.

Require the executive branch to conduct a ten-year capital needs assessment for the State.

Earmark \$61.5 million-\$123.0 million each year for renovation and repair of State buildings as a part of the regular budget process.

Establish appropriations subcommittees for capital improvements in the House and the Senate.

These recommendations when taken together would reform the State's capital budgeting process significantly. To follow through with this reform proposal, the proposed legislative subcommittees on capital improvements should develop State policy regarding the use of bonded indebtedness to finance capital projects. The State's current pay-as-you-go policy does not give the State the flexibility to anticipate future trends in economic growth.

To apply a higher level of planning to the capital budgeting process, the General Assembly should establish appropriations subcommittees on capital improvement in the House and the Senate to focus legislative deliberations on capital issues, develop concentrated expertise, and encourage the development and use of consistent criteria for evaluating the merits of capital improvement project requests.

Legislative oversight focused on program results

Legislative oversight of State agencies focuses on expenditure control rather than program results. The individual findings that support this conclusion are:

- **Agencies (except for some universities) have no incentive to reduce expenditures**
- **Transfer restrictions between personnel and non-personnel line items diverts attention from program results**

These findings and our recommendations are discussed below.